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# 1. Was securitisation the culprit? Explanation of legal processes behind creation of mortgage- backed sub-prime securities

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## INTRODUCTION

The recent global credit crisis, the collapse of large investment and high street banks as well as the nationalisation of Northern Rock have established that misuse of innovative financing techniques such as securitisation might pose an unacceptable level of risk for the global economy. The question is whether securitisation is the underlying causal element of the global credit crisis. Securitisation as a financing technique has had a bad press of late.<sup>1</sup> It has been seen as the culprit in the 2007/2008 financial crisis. The complex nature of securitisation and other structured finance transactions needs to be understood, along with the fact that their failure may lead to the Risk Originator's failure.<sup>2</sup> Thus, securitisation should be used extensively to finance businesses but with caution by people who are aware of the consequences and complexities inherent in this type of financing.

The aim of this chapter is to assess whether securitisation is in fact the reason for the financial crisis. The chapter analyses the significance of securitisation as a financing technique which is critical for raising capital. The recurrent theme is that there is a need for greater transparency and predictability in securitisation. It was the lack of transparency and ambiguous pricing of the sub-prime element of securitised credit risk that caused the crisis in interbank markets. International harmonisation activities on secured transactions may provide assistance for what would have been needed for collateral

debt obligations. Part two elaborates upon the legal technique of securitisation and will examine the relationship between the sub-prime crisis and securitisation. Part three examines current problems experienced in the wholesale interbank markets surrounding the Northern Rock crisis. Concluding remarks will be in part four.

## SECURITISATION AND SUB-PRIME MORTGAGE CRISIS

### Securitisation

Securitisation is a critical financing technique which ‘efficiently allocates risk with capital [and] enables companies to access to capital markets directly’.<sup>3</sup> Simply, in securitisation receivables are firstly pooled by the originator and then sold to an independent special purpose vehicle (SPV), which funds the purchase of receivables by issuing securities that are secured on the receivables to capital market investors.<sup>4</sup> Broadly there are three types of securitisation transactions. These are true sale securitisation, synthetic securitisation and whole business securitisation. True sale is the most common form of securitisation; conversely, synthetic securitisation lacks assignment, which differentiates it from the true sale securitisation. Whole business securitisation is also known as corporate securitisation and certain sections of a company’s income are ring fenced to be securitised to provide additional benefit to securities holders.<sup>5</sup>

Securitized mortgage assets generate liquidity which then is repaid to buyers of mortgage securitisation.<sup>6</sup> The SPV by issuing bonds and notes to investors raises finance. Illiquid financial assets, by being assigned to an SPV, ‘are converted into securities, to facilitate their sale and trade.’<sup>7</sup> Assigned receivables are isolated from the credit risk of the originator and used to create asset or mortgage-backed securities which are granted higher credit rating by the credit rating agencies.<sup>8</sup> In a securitisation transaction there is always an originator that sells the future receivables<sup>9</sup> to be generated from non-marketable assets such as home mortgage loans, credit card or leasing receivables to a special purpose vehicle, which raises finance through issuing securities and these assets become marketable securities.<sup>10</sup> In a securitisation transaction there must be receivables that are securitisable.<sup>11</sup> Often, originators may come together and

sell their receivables to one SPV and by virtue of this they create a multi-party securitisation.<sup>12</sup> This is certainly beneficial for small and medium-sized businesses, as originators, as they will not have to deal individually with the creation of and matters relevant to the SPV, but all of them will deal with and share the burden of creating an SPV. This will be a more affordable way of securitising their receivables.<sup>13</sup> Multi-party securitisation transactions also grant better protection to the investors. The rationale is that in the event of the bankruptcy of one originator in a multi-party securitisation, there will not be any adverse effect on the investors and the SPV.<sup>14</sup>

It is critical that the transfer is a true sale, otherwise in the event of the originator's insolvency the transfer may be recharacterised as a charge (that is, a charge over the receivables granted by the originator to the SPV rather than an outright transfer). However, the consequence of recharacterisation as a charge may have detrimental effects. Firstly, if the originator transfers these receivables under a security agreement thus the originator still owns the receivables, the quality of receivables and their rating value will be negatively affected. This is because the bankruptcy of the originator will also affect the SPV and the status of the receivables<sup>15</sup> and the creditors of the originator may have claims on these receivables. Firstly, a charge granted by a company must be registered under the Companies Act 2006 s. 860. Failure of registration will render the charge void against third parties (liquidator of the company, an administrator of the company and a creditor of the company).<sup>16</sup> Put simply, the SPV as well as the investors will become unsecured creditors as a result of no registration. On the other hand, sale of receivables is not registrable under English law,<sup>17</sup> whereas under Article 9 of the US Uniform Commercial Code (the UCC) security interests over receivables are registrable.<sup>18</sup> Secondly, the rating agency's rating, generally speaking, is made on the assumption that in the event of liquidation, the liquidator should not challenge that the transfer was voided or reversed on the grounds that receivables were transferred by way of security or by a disguised sale transaction.<sup>19</sup> Thus the rating will not be high, which will affect the price of securities. Arguably, the registrability of true sale will allow other assignees to be able to discover the existence of the assignment of the same receivable. It can also assist the screening of borrowers by financial intermediaries. Currently, securitisation reduces the incentives of financial intermediaries' ability to screen borrowers.<sup>20</sup> The effect of

this can be felt especially in the sub-prime mortgage securitisations, where the financial histories of borrowers have not been seriously considered in the rating of securities.

There are certain reasons for companies to securitise their receivables or assets. These receivables may include credit card, trade, mortgage and franchising receivables, oil and gas loans as well as leases of property or equipment such as aircraft. Firstly, securitisation is said to reduce the cost of credit. That is to say that when companies are financed by virtue of bank credits they have to assume the bank's charges, whereas securitisation is inexpensive and not rigid<sup>21</sup> as it presents a direct financing opportunity to the originator. Professor Schwarcz argues that 'increasingly, corporate and consumer financing is originated not from banks per se or from bank deposits but from securitization markets'<sup>22</sup> thus establishing a process of '*dis-intermediation*' where effectively banks as intermediaries of funds are removed. Secondly, securitisation reduces 'mismatches between assets and liabilities and to manage balance sheets better.'<sup>23</sup> Thirdly, securitisation provides competitive financial support benefits for borrowers.<sup>24</sup> Small and medium-sized businesses need securitisation to raise their capitals in order to continue their investments and growth. Finally, even when securitisation is used, an originator firm may wish to maintain contact with the debtors even though assignment is made to the assignee (SPV). In other words, the originator may continue to collect the payments on behalf of the assignee and often in securitisation notice is not given to the debtors, arguably to protect the originator's financial reputation. However, in the absence of registration, notice will determine priority. Priority will depend on the date of notice<sup>25</sup> and failure to give notice to the SPV will result in the SPV losing the priority position if the originator further assigns the same receivable.<sup>26</sup>

The independence of the SPV is particularly critical. The SPV must be bankruptcy remote in order not to be affected by the bankruptcy of the originator. The idea is, mainly, to protect the investors who purchased the securities secured by receivables. The SPV should be separate from the originator's corporate structure and have no legal or equitable relationship with it, such as between a parent and subsidiary. This is achieved through establishing a trust structure where the shares of an SPV are 'held under the terms of a trust for the benefit of charitable institutions'.<sup>27</sup> Unless the SPV is bankruptcy remote, cost of securitisation may be higher and risks may be created

for investors. Rating agencies will be reluctant to rate the bonds at a higher rate and this will make the bonds less marketable. The SPV is a specially created company with a single purpose to raise capital for the originator company and 'is often owned by charitable trustees.'<sup>28</sup> Banks and other financiers establish these trusts, generally, in off-shore jurisdictions where trust law generally favours these financing techniques and structures.<sup>29</sup> The bankruptcy remoteness will give confidence to investors as they will 'focus just on the value of the assets as security for their loan.'<sup>30</sup> The SPV is not intended to be used for making money, but it only functions as a conduit pipe for payments between the originator and the investors of securities and bonds issued by the SPV. As SPVs are often established as charitable trusts they are not for profit and, in case of winding up, all cash raised through the sale of securities must match the mortgages being paid off, thus leaving no cash in the SPV account.<sup>31</sup> Bankruptcy remoteness is also required for capital adequacy, tax and accounting purposes.<sup>32</sup> Off-shore jurisdictions also offer favourable tax treatment, which constitutes another reason for SPVs being established abroad.

### **Sub-prime Mortgage Crisis**

The credit crisis, which takes its roots in the American sub-prime mortgage crisis, has arisen out of a number of interrelated financial, sociological and legal trends. These trends can be enumerated as firstly, the growth of wealth and its utilisation in investments whether or not in an effective way; secondly, the risk-taking strategy of financial sector and individuals; and thirdly, deficiencies in the corporate governance and financial supervision.<sup>33</sup> Risk taking seems to be a particularly significant factor because it involves risky business and lending decisions, which then leaves a narrow or no margin for errors. The lending practices in American sub-prime mortgage markets to borrowers with poor credit histories proved to be risky. Prior to the sub-prime crisis, with the competition among the mortgage lenders to extend as many mortgages as they could so that more commission could be earned, riskier investments were made. Sub-prime borrowers may not have sophisticated financial information, which exposes them to predatory lending.<sup>34</sup> As the first step, borrowers purchased mortgages from brokers or banks with few financial backgrounds checks. Arguably rising house prices was

the fundamental reason why banks lent to people with poor credit histories with the expectation that even if they defaulted in their payments there would still be the possibility to sell these houses and without banks having any actual losses. As the future income from these properties was securitised, clearly the strategy of banks was to sell and recover any monies before the maturity of these securities arising out of sub-prime mortgage securitisations. It is arguable that these are *high-risk loans* because there is no guarantee whether borrowers with poor credit histories will be able to repay (typically the loans are several times higher than the personal income, such income often being unreliable and unverified). These loans were gathered and sold to investment firms and SPVs. These loans and collateralised debt obligations were sold to investors not just in the United States but around the globe. Conversely, rating agencies rather traditionally have given high ratings to mortgage-backed securities because the default rate on those rates were traditionally lower than the asset-backed securities. Moreover, the underwriting standards in those types of assets were different than the normal securitisation practices.<sup>35</sup> However, arguably, one thing is miscalculated. That is the mortgage-backed securities in this crisis were in fact not derived from prime mortgages but from sub-prime mortgages, where the mortgage holder does not have the same financial standing as the prime mortgage holder. The more sub-prime mortgage loans were securitised, the bigger the so called mortgage bubble got. However, as the stability of the mortgage market is dependent upon the income of mortgage holders and the rest of the economy as a whole, with the fall of house prices (partly the result of oversupply in the US), the increase of interest rates and default of mortgage holders who compromised borrowers in what is now termed the *sub-prime market* who could not keep up with the payments, the sub-prime mortgage crisis unfolded. Those mortgage holders typically with very low income or with negative credit histories did not have refinancing options.<sup>36</sup> The depreciation of housing prices and the default in repayment of mortgages deterred financiers and investment companies from buying further mortgage-backed securities as these products lost their stability.

However as the sub-prime mortgage crisis itself developed, the broader financial outlook began to seem more dismal. The breaking point, arguably, converting the sub-prime mortgage crisis into a global financial crisis related to the maturity of securities which had

been left unpaid. When the mortgage-backed securities matured, investors in these securities could not sell their securities due to mortgage borrowers' default, whose payment finances the mortgage-backed securities. Lack of liquidity led to banks being reluctant to lend to each other and particularly, due to suspension of inter-bank lending, smaller banks experienced liquidity problems and as they frequently borrow from larger banks, they were under financial distress. This is particularly true for building societies that did not have the same scale of deposit base as high street banks, and also true of banks (such as Northern Rock) that relied on short-term borrowing from larger banks and other financial institutions to finance their mortgage lending business to a greater extent than they relied on a longer-term deposit base.

The exposure of a number of issues by the credit crisis such as the interrelation of the banking system, capital markets and payment systems and transparency of the securitisation market require particular attention.<sup>37</sup> Firstly, globalisation of financial markets has not been accompanied by an attendant globalisation of legal certainty relating to financial market transactions. The misuse of the securitisation technique and financial markets' failure to foresee the approach of the crisis caused problems both for banks and small and medium-sized businesses that need access to low-cost credit. During that process banks had to repossess assets and particularly, the properties that were mortgaged but unpaid and register 'back on their books; backstop lines of credit were triggered; and banks could no longer securitize loans, increasing the pressure on their balance sheets.'<sup>38</sup> Lack of ability to securitise loans increased the cost of credit and reduced availability of credit. The increased cost of credit had a negative impact on the small and medium-sized enterprises that need low-cost credit to expand business and, in general, economic growth was hampered when the asset values declined and the global economy has become fragile more than ever. Secondly, the transparency issue has proved to be a significant element in the crisis. As securitisation has an extremely complex and technical structure and involves certain risks, there must be transparency in the way the quality of loans and the relevant risks are disclosed to investors. Professor Schwarcz argues that despite the disclosure about the risks involved in mortgage-backed securities, the disclosure proved to be insufficient and the complex nature of securitisation as well as the length of documentation in the offering of these securities has had



an impact on the insufficiency of information in this market.<sup>39</sup> It is indicated that lack of transparency has occurred in different levels and dimensions of securitisation. These include valuation, pricing and concentration of risk.<sup>40</sup> The complexity of valuation of securitised assets, obligations and collateralised debt obligations as well as the lack of pricing information of mortgage-backed securities, which is caused by lack of transparency, has led to uncertainty and loss of confidence.<sup>41</sup> The complex nature of mortgage-backed securitisation has led to the insufficiency of disclosure as investors were not certain in relation to the value of the securities that they have invested on. The insufficiency of disclosure and the complexity of securitisation transactions exposed investors to risk. This is also called the 'concentration of risk' according to which lack of detailed reporting of exposures caused the market participants to be non-informed of the risks, which then 'led to a reluctance to engage with counterparties [and] pushed up spreads and reduced liquidity further.'<sup>42</sup> The lack of sufficient liquidity is the fundamental problem which derived from securities' loss of market value, which led fewer buyers to purchase these securities. Thus the financial institutions holding these securities were left with securities which could not be sold and they became insolvent not in the traditional sense, but as they cannot pay the matured securities due to their lack of liquidity (which may also be termed as *liquidity squeeze*), they had to choose the bankruptcy option.<sup>43</sup>

Following the credit crisis of 2007/2008, investment banks have invented certain new financing schemes to reduce the capital cost of risky assets on banks' balance sheets. This type of scheme is often called 'smart securitisation' or rather misleadingly 'insurance'.<sup>44</sup> Although the scheme is similar to the traditional securitisation there appear to be some differences. Firstly, under traditional securitisation there is new lending whereas smart securitisation involves the securitisation of existing risky assets on the balance sheets of banks rather than involving the discredited collateralised debt obligations; and secondly, smart securitisation scheme does not disguise the transfer of risk.<sup>45</sup> This new scheme, in effect, aims to reduce the capital requirements of banks that need to be held against the assets by reducing the cost of risky assets on the capital. However, this seems to go against the idea of strengthening bank capital.<sup>46</sup> The scheme also seems to be another excellent example of how a financing technique may still be misused despite the recent financial crisis.

## NORTHERN ROCK, GRANITE, SECURITISATION AND CRISIS

Northern Rock was a bank that specialised in domestic mortgage lending. It also operated as a traditional high street bank. However, the growth of Northern Rock was due to the size of its loan portfolio from its securitisation practice rather than its high street banking practices, where competitively priced mortgages were extended. Northern Rock operated its securitisation scheme through its SPV, a charitable trust, Granite Finance Trustees Limited. Granite was established in 1999 as an off-shore company in Jersey. As it was a charitable trust and separate from the structure of the Northern Rock, it had not been affected by the nationalisation of its originator; Northern Rock over the years had transferred some portions of mortgages to Granite. These transferred mortgages were worth approximately '67% of the value of the properties they are secured against.'<sup>47</sup> Generally speaking, the competitiveness of Northern Rock in the market was sustained through borrowing from lenders and other banks both from the UK and international markets. These funds were used to provide mortgages to borrowers which were then securitised in the financial markets. Arguably, one of the elements in Northern Rock's failure was entering into sub-prime mortgage securitisation arrangements and its aggressive securitisation strategy. In 2006, Northern Rock began lending to sub-prime borrowers and Lehman Brothers assessed the borrowers' risk and creditworthiness and in the summer of 2007 the interest rates on those sub-prime mortgages were increased.<sup>48</sup> Following the depreciation of US house prices, which triggered the sub-prime mortgage crises, investor demand for sub-prime mortgage securities decreased. Defaults occurred in the payment of mortgage-backed securities upon their maturity, the payment of which depended on the borrowers' financial standing, Northern Rock was led to default in repayments to its lenders. Arguably, Northern Rock's operation was similar to predatory lending in relation to sub-prime mortgages and the bank had an information advantage over the securities arranger about the borrower's financial standing. In that context, it could be argued that Northern Rock was also involved in predatory borrowing and lending practices. In this latter scenario, normally the originator makes representation and warranties so that the underwriting process can be completed.<sup>49</sup> Following the default in repayment

to lenders, Northern Rock approached the Bank of England to borrow money in order to continue to meet its day-to-day business funding requirements, which led to a depositor run on the bank.<sup>50</sup> As a final resort Northern Rock was nationalised.<sup>51</sup> It is arguable that behind the nationalisation decision lay the complex nature of the securitisation relationship between Northern Rock and its SPV, Granite. Granite held the 40 per cent of Northern Rock's assets<sup>52</sup> and was supplied regularly with securitised mortgages when the old mortgages were matured and paid out; however, this led to the inapplicability of insolvency administration appointment procedure because of the fear that investors might have demanded the payment of the amount held in Granite, hence nationalisation rather than insolvency of Northern Rock.<sup>53</sup>

The relationship between Northern Rock and Granite has significance in the period leading to nationalisation. Northern Rock employed a risky and aggressive securitisation model often called *originate and distribute* model (or O & D) and this was the key to the financing of its business and lay behind its spectacular growth up until 2007. According to this model loans of poor quality are not held to maturity but bundled and packaged extensively and sold to investors by Granite. Some of the problems originating from this O& D model can be summarised as piling up of large quantities of super senior tranches of securitisation deals in the bank's books, which have been kept to minimise underwriting costs. This in turn gave misleading signals as to the exact status of liquidity of banks, as the distribution was not quick enough and this increased the inventory risk of the bank.<sup>54</sup> Empirical data showed that with lack of screening incentives (that is, the more the distance between the originators and investors, the less the possibility to screen originators and conduct healthy due diligence-monitoring and assessing credit risks) combined with a risk taking tendency, this model proved to be a major contributor to the sub-prime mortgage crisis.<sup>55</sup> Furthermore, the risk was also that originators could not properly assess the risks involved in the assets and due diligence could not be made. Investors also could not perform a careful due diligence as a result of limited information in this market. Thus, investors would depend on the ratings provided by the credit rating agencies.<sup>56</sup> However, credit rating agencies in the past have been misled purposefully or knowingly by originators and SPVs during the Enron scandal, where risky assets were kept off balance sheets and in the SPVs books. This

distorted credit rating agencies' ratings and abusive and manipulative behaviour occurred.<sup>57</sup> A further significant aspect of Northern Rock and Granite relationship, which seems to be standard in every originator-SPV relationship,<sup>58</sup> arises out of the ambiguity in the risks associated with off-balance sheet vehicles. Granite was an off-balance sheet vehicle that purchased loans generated from the bank's O & D model. These have contributed to the crisis by smoke screening the real nature of the liquidity problems they have. It has been pointed out that:

[t]he issue of off-balance sheet funding has emerged as an important issue because, during the recent market turbulence, contractual obligations of banks to off-balance sheet vehicles in the form of contingent liquidity facilities, or even non-contractual reputational considerations, has required banks to provide funding for and/or reabsorb the assets backing these structures at a time of severe stress in the market.<sup>59</sup>

Thus the House of Commons Treasury Committee indicated that the Financial Services Authority 'must ensure that banks report their exposure to off-balance sheet vehicles appropriately.'<sup>60</sup> Arguably the more transparency achieved in this area, the more predictable the financial standings of Banks will be.

## CONCLUSIONS

The lack of access to credit by small banks as well as small and medium-sized enterprises caused by the sub-prime mortgage crisis has often different dimensions such as recession, loss of jobs, repossession of properties as well as bankruptcies of large and prominent investment banks such as Lehman Brothers or nationalisation of banks such as Northern Rock and Bear Stearns. In that context, securitisation is critical in raising finance.

The title of this chapter poses the question as to whether securitisation is the true culprit of the past few years, but it is argued here that it is not. Rather it is capable of being a clear and efficient financing mechanism. It is also clear that the reckless business strategy employed within the last 10 years by Northern Rock to the detriment of the resilience of its liquidity position<sup>61</sup> demonstrates the fact that securitisation as a sophisticated financing technique is not in itself the culprit. Like many sophisticated financing techniques it is

complex, as it involves both financial and legal technicality and lacks transparency for the investor and borrower. The financing technique involves heavy human input in the decision making, lending, borrowing, underwriting and investment processes. The transparency of the relationship between the originator, SPV, investor, rating agencies and debtors will determine the quality of transaction and financing. This process involves moral hazard and human error. In relation to human errors and the human factor in the crisis, the House of Commons Treasury Committee summarised the participation of directors as follows:

The directors of Northern Rock were the principal authors of the difficulties that the company has faced since August 2007. The directors pursued a reckless business model, which was excessively reliant on wholesale funding. The Financial Services Authority systematically failed in its regulatory duty to ensure that Northern Rock would not pose a systemic risk.<sup>62</sup>

The fact that securitisation involves risks and encourages risky lending practices should not deter investors. Credibility with investors must be rebuilt in order to benefit from the advantages of securitisation by being more transparent, explaining the risks inherent in the process including the quality of the assets and the contractual structure and by improving the banking risk management structures.<sup>63</sup> Nevertheless, transparency should be maintained and promoted in order to ensure that relevant due diligence is conducted by investors to have fuller information on the complex nature of the transaction as well as risks involved.<sup>64</sup> However, it should be noted that reliance on the ratings given to these types of products by the rating agencies without due diligence and the desire to have more commission in the competition atmosphere without considering the risks involved in a volatile market should be blamed. The default or the downgrading of credit ratings of mortgage backed securities or other obligations caused investors to lose their confidence in financial markets. This is because their collateralised debt obligations, mortgage-backed securities or asset-backed securities were highly rated by rating agencies.<sup>65</sup> Finally, banks must maintain adequate capital to shield themselves, the financial markets and the broader economy from the risks of future bank failures caused by any future disruptions to their operations and soundness. The reforms are now underway to the Basel II measures of regulatory capital for banks

need to recognise the need to map the risks of an individual bank's securitisation activities and their holdings of complex securitised obligations into hard form capital requirements that are implemented and enforced. This will require regulators and supervisors to be more aware of and vigilant to the uses of securitisation as a financing technique as well as to its abuses.

## NOTES

1. See e.g. *Financial Times* Letters, 'The main point about black swans and credit crises', 17 May 2008 '... As George Soros put it: "Securitisation had the effect of transferring risk from people who are supposed to know risk and know the borrowers to people who don't."'; *Financial Times* Comments: 'Life could yet follow death for the idea of Securitization', 3 October 2007.
2. Schwarcz, S. (2006) 'The Public Responsibility of Structured Finance Lawyers' (1) *Capital Markets Law Journal* 6 at 6.
3. Schwarcz, S. 'The Future of Securitization' *Duke Public Law and Legal Theory Research Paper Series No. 223*, November 2008, at 1.
4. See e.g. Arner, D. (2002) 'Emerging Market Economies and Government Promotion of Securitization' (12) *Duke J. Comp. & Int'l L.* 505; Frankel, T. (1998) 'Cross Border Securitization: Without Law, But not Lawless' (8) *Duke J. Comp. & Int'l L.* 255; Hill, C.A. (1996) 'Securitization: A Low Cost Sweetener For Lemons' (74) *Wash. U. L. Q.* 1061; Schwarcz, S. (2004) 'Securitization Post-Enron' (25) *Cardozo L. Rev.* 1539 at 1540; McCormack, G. (2004) *Secured Credit under English and American Law*, Cambridge: Cambridge University Press, at 238.
5. For more detailed information on the types of securitisation see e.g. De Vries Robbé, J.J. (2008) *Securitization Law and Practice In the face of the Credit Crunch*, Alphen aan den Rijn: Kluwer, pp. 5–6.
6. 'Memorandum from the Financial Services Authority', para 3, available at <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56we08.htm> (accessed 10 June 2010).
7. Frankel, T. (2002) 'The Law of Cross-Border Securitization: Lex Juris' (12) *Duke J. Comp. & Int'l L.* 475 at 477.
8. Petkovic, D. (2000) 'New Structures: 'Whole Business' Securitizations of Project Cash Flows' (15) *J.I.B.L.* 187 at 187.
9. Under English law it is possible to assign future receivables, *Tailby v. Official Receiver* (1888) L.R. 13 App. Cas. 523; *Holroyd v. Marshall* (1861) 10 HL 191
10. Goode, R. (2004) *Commercial Law* (3rd ed.) London: Butterworths, at 147–8.
11. See generally Scott, S. and Wellons, P.A. (1997) *International Finance Transactions, Policy and Regulation* (4th ed.) New York: Foundation Press at 771–2 where they state that:

[i]nvestors in securitized receivables often seek the following . . . to reduce their risk: Large pool: [as size] makes [the issuance of a security] feasible, since it is too expensive to market an issue of a few hundred thousand dollars and since it permits reliable performance forecasts . . . Low default rate: High asset quality and small credit risk reduce the financing cost for the [securitisation] . . . Insensitivity to interest rate changes: The debtors'

payments should not be altered by changes in interest rates . . . Credit enhancement, such as guarantees or collateral . . . Limited prepayment risk [and] short maturity.

12. Multi-Party Securitisations are also known as ‘Multi-seller Securitisations’ *see generally* Schwarcz, S. (1994) ‘The Alchemy of Asset Securitization’ (1) *Stan. J. L. Bus. & Fin.* 133 at 140 *et seq.*
13. *See generally* Schwarcz, *above* at 140 *et. seq.* where Professor Schwarcz states that ‘multiseller securitisation conduit’ offers an originator the opportunity to minimize their transaction costs by utilizing a common SPV.’
14. For a similar view *see* Schwarcz, *above* at 140 where Professor Schwarcz states that ‘most multiseller securitization conduits have accommodated only investment grade originators [and] selectivity minimizes the risk – already rendered unlikely because of the bankruptcy remote structure – that a single originator’s bankruptcy might adversely impact a conduit engaged in transactions with many originators.’
15. For a similar view *see also* Schwarcz, *supra* note 4, at 1543 where Professor Schwarcz states that:

the SPV’s investors will continue to be repaid in the event of the originator’s bankruptcy. If the SPV owns the financial assets, its investors will continue to be repaid; if not, their right to be repaid will be suspended and subject to possible impairment. The SPV will own the financial assets only if the transfer of those assets from the originator to the SPV constitutes a sale under applicable bankruptcy law – usually referred to as a ‘true sale.’

16. Companies Act 2006 s. 874(1).
17. Currently under English law assignment by way of sale (outright transfers) are not registrable. The Law Commission in its Consultation papers and Report recommended the registration of sale of receivables. Law Commission Consultation Paper No. 164, para. 7.45; Law Commission Report No. 296, paras 1.12 and 4.25.
18. UCC§9–310. It should be noted that security interest under UCC Article 9, by virtue of functional approach to security, also includes outright sale of receivables in order to include them in the notice filing system. However, registration of outright sale of receivables does not convert them into a security transaction. They will be treated similarly for priority and perfection purposes but differently for enforcement.
19. For recharacterisation risk *see* Law Commission Consultation Paper No. 164, para. 6.34 *et seq.*
20. *See generally* Keys, B.; Mukherjee, T.; Seru, A. and Vig, V. (2008) ‘Did Securitisation Lead to Lax Screening? Evidence from Sub-prime Loans’ *EFA 2008 Athens Meetings Paper*.
21. Petkovic, *supra* note 8 at 187, stating that ‘[c]apital markets financing is less expensive and more flexible than bank finance . . . anks . . . charge margins on their cost of funds that need to cover capital adequacy costs, return on shareholders’ equity, funding costs and profit margins . . . [and] need to charge for credit risk . . .’
22. Schwarcz, S. (2009) ‘Too Big to Fail?: Recasting the Financial Safety Net’ *Duke Public Law and Legal Theory Research Paper Series No. 235*, at 2.
23. Scott and Wellons, *supra* note 11 at 770.
24. Petkovic, *supra* note 8 at 187.
25. *Dearle v Hall* (1823) 3 Russ 1.

26. For the risk involved in the absence of a comprehensive registration system *see* Law Commission Consultation Paper No. 164, paras 6.36 and 6.37.
27. *Supra* note 6, para. 5.
28. Goode, *supra* note 10 at 147.
29. *Granite: Northern Rock's Money-Making vehicle* available at <http://www.thisismoney.co.uk/granite> (accessed 10 June 2010).
30. See generally Ambery, R. (2003) 'Securitisation in the UK: The Final Frontier' *IFLR*
31. See *supra* note 29.
32. Goode, *supra* note 10 at 148.
33. Cowen, T. 'Three Trends and a Train Wreck' *N.Y. Times*, 17 October 2008, available at <http://www.nytimes.com/2008/10/19/business/19view.html> (accessed 10 June 2010).
34. For contractual design features of sub-prime mortgage contracts and the effects of this on unsophisticated borrowers *see* Bar-Gill, O. (2009) 'The Law, Economics and Psychology of Subprime Mortgage Contracts' (94) *Cornell L. Rev.* 1073 at 1096 *et seq.*
35. See De Vries Robbé, *supra* note 5 at 7–8.
36. See generally Schwarcz, S. (2009) 'Understanding the Subprime Financial Crisis' (60) *S. C. L. Rev.* 549 at 550; Schwarcz, *supra* note 22 at 3 *et seq.*
37. On these and other issues including system dynamics, incentives and response of central banks to asset bubbles *see generally* Dudley, W. (2009) 'Lessons learned from the Financial Crisis' *Remarks at the Eighth Annual BIS Conference.*
38. Dudley, *above* at 1.
39. Schwarcz, S. (2008) 'Disclosure's Failure in the Subprime Mortgage Crisis' (3) *Utah L. Rev.* 1109 at 1110.
40. Dudley, *supra* note 37 at 3.
41. Schwarcz, *supra* note 36 at 557; Dudley, *supra* note 37 at 3.
42. Dudley, *supra* note 37 at 3.
43. For a discussion of reduced liquidity and insolvency of financial institutions *see* Schwarcz, *supra* note 36 at 552–4; for some discussion on the problems of liquidity squeeze *see* Caprio Jr., G.; Demirgüç-Kunt, A. and Kane, E.J. 'The 2007 Meltdown in Structured Securitization: Searching for Lessons not Scapegoats' *World Bank Policy Research Working Paper No. 4756.*
44. Jenkins, P. 'Securitisation reinvented to cut costs' *Financial Times* 5 July 2009. Goldman Sachs addresses this scheme as *insurance* whereas Barclay Capital calls it *smart securitisation.*
45. *above.*
46. Lex, 'Smart Securitisation' *Financial Times* 5 July 2009 where it is argued that a new scheme such as this reduces the need for the tax payer to fund bank bail-outs.
47. See *supra* note 29.
48. <http://news.bbc.co.uk/1/hi/business/6961620.stm> (accessed 10 June 2010).
49. For different scenarios on securitisation and sub-prime mortgage credit *see* Ashcraft, A. and Schuermann, T. (2008) 'Understanding the Securitisation of Subprime Mortgage Credit' *Federal Reserve Bank of New York Staff Reports* No. 318.
50. For insolvency and corporate governance perspective on the run *see e.g.* Tomasic, R. (2008) 'Corporate Rescue, governance and risk taking in Northern Rock, Part 1' *Comp. Law.* 297; Tomasic, R. (2008) 'Corporate Rescue, governance and risk taking in Northern Rock, Part 2' *Comp. Law.* 330.
51. See generally HM Treasury 'The Nationalisation of Northern Rock' (2009)



- available at [http://www.nao.org.uk/publications/0809/northern\\_rock.aspx](http://www.nao.org.uk/publications/0809/northern_rock.aspx) (accessed 10 June 2010)
52. 'Northern Rock's 'Best Mortgages' Sold Offshore' Robert Winnett 21 February 2008 <http://www.telegraph.co.uk/news/newstopics/politics/labour/1579384/Northern-Rocks-best-mortgages-sold-offshore.html> (accessed 10 June 2010).
  53. Tomasic, Part 1, above at 298.
  54. 'Securitisation and the Originate and Distribute Model: Does it have a Future?' Speech given on 21 April 2008 by Thomas Huertas, Director Banking Sector, FSA, [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0421\\_th.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0421_th.shtml) (accessed 10 June 2010).
  55. See generally Purnanandam, A. 'Originate-to-Distribute Model and Sub-prime Mortgage Crisis' AFA 2010 Atlanta Meetings Paper April 2010; Fender, I. and Mitchell, J. 'Incentives and Tranche Retention in Securitisation: A Screening Model' available at [http://www.bis.org/bcbs/events/cbrworkshop09/fender\\_mitchell.pdf](http://www.bis.org/bcbs/events/cbrworkshop09/fender_mitchell.pdf) (accessed 10 June 2010).
  56. For the problems involving originate distribute see House of Commons Treasury Committee, 'Financial Stability and Transparency Sixth Report of Session 2007–08', para. 178 at 62, available at <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/371/371.pdf> (accessed 10 June 2010).
  57. See generally Schwarcz, *supra* note 4.
  58. See House of Commons Treasury Committee, 'Financial Stability and Transparency Sixth Report of Session 2007–08', para. 47, at 19.
  59. *above* para. 152 at 54.
  60. *above*, para. 216 at 77.
  61. Evidence of the Governor of the Bank of England Mervyn King before the House of Commons Treasury Committee, *see generally* House of Commons Treasury Committee, 'The Run on the Rock' (2008), para. 29, at 18.
  62. House of Commons Treasury Committee, 'The Run on the Rock' (2008), at 3.
  63. 'Securitisation and the Originate and Distribute Model: Does it have a Future?' Speech given on 21 April 2008 by Thomas Huertas, Director Banking Sector, FSA, [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0421\\_th.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2008/0421_th.shtml) (accessed 10 June 2010).
  64. House of Commons Treasury Committee had suggested an approach in this direction, *see* House of Commons, Treasury Committee, 'Financial Stability Transparency' (2008), *supra* note 56 para. 166 at 58.
  65. See generally Schwarcz, *supra* note 3 at 4 *et seq.* For the contribution of rating agencies to the credit crisis *see e.g.* Hurst, T. (2009) 'The Role of Credit Rating Agencies in the Current Worldwide Financial Crisis' *Comp. Law.* 61 at 61 where it is argued that 'reckless speculation in real estate, overly leveraged financial institutions with too little equity capital, the [abusive] securitisation of mortgages and other financial instruments with insufficient understanding of the risks involved, and many other factors all contributed to the current financial meltdown.'